IAS PORTFOLIO INSIGHTS


THE REBALANCING CONUNDRUM: PE VALUATIONS & MARKET DISLOCATIONS

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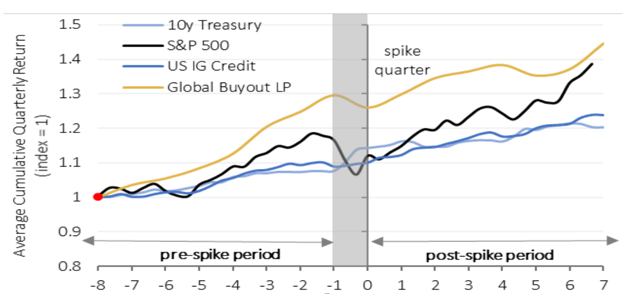
Private assets have had phenomenal returns over the past decade. Global buyout funds delivered a stunning 21.9%/y return for the last 3y and 16.2%/y for the last 10y. In contrast, in the public space, the S&P 500 had a considerably lower 12.4%/y 10y annualized return. Not surprisingly, institutional investors have increased their portfolio allocations to private equity (PE) considering its higher returns and diversification potential that public assets may not be able to match. Over the past decade, PE buyout funds AUM has grown 7% compounded annually.

With PE's strong performance, CIOs may be facing the rebalancing conundrum: if and how to rebalance PE back to target allocation and whether there is sufficient liquidity to do so.

The rebalancing conundrum becomes acute during periods of public market dislocation when public asset performance declines sharply relative to PE leading to an over-weight – "on paper" – to PE, a phenomenon commonly known as the "denominator effect." Many CIOs find their PE allocations rise far above target allocations.

Getting back to target allocation during periods of market turmoil may require CIOs to sell PE investments. However, this could be expensive during market dislocations when PE is likely to be priced at a discount in secondary markets. Such periods may be attractive for buying, not selling, PE. In addition, efforts to rebalance between PE and public assets may prove unnecessary as public market declines are often reversed quickly. Finally, PE secondary market opportunities may be limited when public markets recover, posing a challenge to CIOs who would then want to buy PE to maintain allocation. Perhaps a more sensible rebalancing strategy design is to gradually rebalance the portfolio without actively trading PE.



Source: Datastream, FRB St. Louis (FRED) and PGIM IAS.

A key contributor to the rebalancing conundrum is the difficulty of PE valuation. One valuation approach relies on GP-supplied reported NAVs, reflecting the GP's informed judgment on the value of portfolio assets which may be insensitive to the ups and downs experienced in the public markets. Another approach makes PE values very sensitive to public market returns, reflecting skepticism of reported PE values as the PE's "true" value. For CIOs, the challenge remains as to how to strike the appropriate degree of sensitivity.

Since portfolio rebalancing decisions hinge on PE valuation, we explore three PE valuation approaches with different implied sensitivities to contemporaneous public market returns. The first two approaches – with low and moderate sensitivity to public market returns – can incorporate commitment history and pacing strategy, thus connecting a PE investment's valuation with its cash flow profile (distributions and contributions) from which liquidity implications of a portfolio's PE allocation can be measured. A third approach strictly ties PE valuation change to contemporaneous periodic public returns but lacks a connectivity to PE cash flows.

We assess the portfolio allocation implications for the two PE valuation approaches with high and low sensitivity to the public market returns in the context of a stressed public market scenario with a fast and sharp rebound. Following the most market-sensitive PE valuation approach, both public equity and PE allocations drop below target (while debt rises above target), requiring buying both public equity and PE to get back to target – which may be attractive when the market is down. In contrast, with the less market-sensitive PE valuation approach, the PE allocation rises above, and public equity drops below, target requiring selling PE into a weak market.

The choice of PE valuation approach may also rest on the investor type, their objective of investing in private assets and their liquidity constraints. For a defined contribution plan vulnerable to daily withdrawals, a public market downturn could motivate immediate participant withdrawal requests. A lagged PE performance update may benefit some "first-mover" participants over those who remain. These plans may have little choice but to use a market-sensitive PE valuation approach – but at least it may give the remaining participants (now holding more than their pro rata share of PE) an opportunity to gain a potential counter-cyclical PE trading advantage as compensation for providing liquidity for those who withdraw.

CIOs can consider grouping PE and public equity together as a single "growth asset" and rebalancing between debt and the growth asset

In contrast, defined benefit plans and sovereign funds do not have to worry much about withdrawals and may be more comfortable using reported (i.e., less market sensitive) valuations. However, to avoid costly PE rebalancing, these CIOs may wish to consider a rebalancing strategy that groups PE and public equity together as a single "growth asset," since public and private equity share similar risk exposures and investors commonly pass any PE net cash outflows through public equity. In this case, portfolio rebalancing involves rebalancing between debt and this growth asset. Following this strategy, overall debt-growth asset allocation target is achieved, even if public equity and PE do not align within their own respective target.

See J. Shen and M. Teng, '*The Rebalancing Conundrum: Private Equity Valuations and Market Dislocations*,' PGIM IAS, December 2021.

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IAS 0309-700